

NEEDED: A GLOBAL RESPONSE
TO THE
GLOBAL ECONOMIC AND FINANCIAL CRISIS

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The financial and economic crisis is a global phenomenon. No country has been spared. The downturn has been, and continues to be, rapidly transmitted across borders through both trade and financial channels².

A global policy response is therefore imperative. Unfortunately, the reactions to date have been limited to individual national efforts. Some countries, like China and the United States, have adopted sizable fiscal and monetary stimulus programs that will be extremely helpful. Others, including most of Europe and some of the emerging market economies, have done relatively little. My colleague Simon Johnson has analyzed the causes of the crisis and presented a pessimistic forecast of the outlook in the absence of major new policy measures, and I will suggest what those measures should be.

The upcoming G-20 summit in London on April 2 offers the best (and perhaps last) opportunity to launch the needed global policy package. The G-20 countries account for about 80

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² Table 1 (attached) indicates the different degrees of exposure to the crisis among the G-20 countries.

percent of the world economy and could thus have a decisive impact. The summit will be the first multilateral meeting for President Obama, appropriately so in light of the gravity of the economic situation and the priority that he has rightly accorded these issues in the early days of his Administration.

The G-20 should adopt a four-part policy package to arrest the continuing decline of world output and promote recovery over the course of 2009 and into 2010:

- major fiscal stimulus by virtually all member countries;
- a comprehensive political commitment to avoid all new protectionist trade distortions;
- mobilization of large amounts of capital to support beleaguered developing countries, mainly through the International Monetary Fund; and
- initial steps toward reform of financial regulation to reduce the risk of future crises.

Fiscal Stimulus

With private financial markets still largely frozen and consumer confidence at record lows, ambitious new government stimulus will be the only way to restore adequate growth of demand in the world economy for the foreseeable future. Much of this stimulus must be provided by central banks, along with the essential supports for the financial systems themselves, through both injections of massive amounts of liquidity and easing of monetary policies. Fortunately, most central banks have now moved decisively in this direction. In any event, most of the G-20 central banks are independent of their governments; they are thus not participating in the London summit nor would it be propitious for the governments to address the monetary issues overtly and publicly.

This requires governments to use fiscal initiatives to make their needed contribution to recovery. To date, the G-20 countries have adopted stimulus programs amounting to 1.4 – 1.7 percent of their aggregate GDP (see attached table 2). No more than half a dozen of them have adopted expansions equaling two percent of their economies, which has been the notional international target advanced by the IMF and others to this point. The IMF estimates that the real economic impact of the measures to date will be under one percent of global output in 2009 and only a few tenths of one percent in 2010.

In light of the rapid deterioration of the growth outlook, the G-20 in London should adopt more ambitious fiscal stimulus targets of three percent of their economies for each of the next two years. This would inject total new demand of perhaps \$1 - 1.5 trillion into the world economy in both 2009 and 2010³. Countries that can and should do more clearly include Brazil, Canada, France, Germany, Korea and Mexico⁴.

There are at least four reasons why the fiscal stimulus program should be coordinated globally. First, it will probably be much too small unless all major countries contribute to it. Second, it would then be unbalanced geographically and lead to a renewal (or even further increase) in the global imbalances (US deficit, Chinese and Japanese surpluses) that helped bring on the crisis in the first place. Third, “free riding” by non-participants will be widely perceived elsewhere as unfair and add to the risk of protectionist trade reactions (see below). Fourth, and perhaps most important, widespread participation will reduce the risk that any individual country will be penalized by the markets for adding temporarily to its fiscal deficit.

³ Global output now totals about \$60 trillion, of which about \$50 trillion is accounted for by the G-20. Additional government stimulus of three percent would thus amount to about \$1.5 trillion per year and, with a multiplier effect of something less than 1:1, probably increase world demand by somewhere between \$1 – 1.5 trillion.

⁴ Truman, Edwin M. February 24, 2009. “Assessing Global Fiscal Stimulus: Is the World Being Short-Changed?” on Peterson Institute for International Economics’ Real Time Economic Issues Watch, online. Available at: <http://www.petersoninstitute.org/realtime/?p=497>

Each country would decide how to shape the details of its fiscal package⁵. “Credit” would be given for programs that were already launched in response to the crisis, such as the recent \$787 billion legislation in the United States and the \$586 billion effort in China. A couple of the financially more precarious G-20 countries, such as Turkey and perhaps Italy, might be excused from the commitment because of the fragility of their budget positions and shaky credit ratings.

The key conceptual issue is to view each of the national stimulus programs as part of a comprehensive global strategy. In light of the intimate trade and financial linkages among virtually all countries that have now been so clearly revealed, including all G-20 countries, it is essential to spur global demand if any individual nation is to experience an early turn-around. One of the key lessons from the Great Depression is that worldwide expansion policies were a key factor in generating recovery and growth across a wide range of countries in the 1930s⁶.

Avoiding Protectionism

It is also imperative that the G-20 countries adopt a firm political commitment to avoid adoption of any additional measures that would distort international trade and financial flows.

Their pledge to do so at their previous summit on November 15 has already been violated by at least seventeen members of the group (excepting only Japan, Mexico and Saudi Arabia). This has already led to emulation⁷ and retaliation by trading partners. The obvious risk is that world

⁵ There have been proposals for international coordination of at least some components of the stimulus packages, such as those aimed at environmental objectives and especially at global warming. There would be no harm in such efforts but they could divert attention from the overriding objective of responding to the economic crisis so should not be emphasized.

⁶ Romer, Christina D. March 9, 2009. “Lessons from the Great Depression for Economic Recovery in 2009.” Speech at the Brookings Institution, Washington D.C.

⁷ Two noteworthy examples are actual or potential emulation of the US bailout of its auto companies by at least half a dozen other countries and Australia’s reaction to the EU reintroduction of export subsidies for its dairy industry.

trade, which is declining for the first time in over 25 years, will fall sharply and produce a downward spiral of global growth as it did in the 1930s.

It will not be good enough for the G-20 to reiterate their fealty to their international legal commitments. The rules of the WTO are exceedingly porous and “legal protectionism” is just as dangerous as any other kind. Moreover, there are no rules to effectively cover international investment. The London pledges must be comprehensive.

They also need to cover all types of trade distortions: increased import barriers, higher export subsidies, domestic subsidies (e.g., for automobile industries) that discriminate against foreigners, strictures on international lending (e.g., complaints that financial institutions receiving government support have made new loans to foreigners) and other measures that have similar effects. The November 15 pledge should also be extended at least through 2010 (as opposed to “the next 12 months” in the initial G-20 statement). In addition, it should invite non-G-20 countries to “take the pledge.”

To promote effective implementation of the new commitment, the G-20 countries (and any other signatories) should agree to notify the World Trade Organization of any steps they take – or that they observe others taking – that might raise questions concerning consistency with the new commitment. On the basis of that information and all other sources available to him, the Director General should publish monthly reports on all violations (by G-20 and other governments, whether or not they have adopted the pledge). The objective is to “name and shame” any deviations from the agreed program in an effort to both deter such behavior and to sanction it in the court of public opinion⁸.

⁸ This invocation of peer pressure has already worked on at least two occasions: the Congressional modification of the Buy American provision in the stimulus package after the initial House version triggered an international uproar, which was also encouraged by President Obama’s strong urging in that direction as he responded to the worldwide

Countries are seeking to export their way out the current crisis through competitive currency depreciation as well as by erecting new trade distortions. The G-20 should therefore also direct the WTO to get together with the IMF to start providing effective sanctions against such behavior. Operating fully within the current charters of both organizations, the Fund would certify that a surplus country was maintaining a competitively undervalued exchange rate, perhaps by intervention in the exchange markets or other forms of manipulation, and the WTO would then authorize its members to bring cases against the offending country. This process could lead to the imposition of retaliatory trade barriers against an offender, both deterring the practice and providing an effective defense against its most pernicious consequences.

The global nature of the problem is again paramount. The fundamental reason for avoiding protectionism, including in domestic stimulus programs like the recent US fiscal package and in the use of financial rescue funds, is that the basic objective is to enhance global demand. Buy-national restrictions, or lend-national requirements, obviously subvert that goal and must therefore be avoided.

The United States has a particular interest in this part of the package. Rapid export growth and sizable reductions in our trade deficit – which has fallen by about half from its peak in 2006 – kept the US economy growing for a full year, from late 2007 through the third quarter of 2008, even though domestic demand was already declining due to the onset of the financial crisis. With the renewed strengthening of the dollar, we should in particular be expanding the activities of our export support programs (especially the Export Import Bank) and pursuing trade policies that seek to further open markets around the world.

reaction, and withdrawal of the “no outsourcing” provision in the original French plan for supporting its auto industry after many of its EU partners lodged angry protests.

Mobilizing Resources for Developing Countries

Developing countries now make up roughly half the global economy⁹. Hence their ability to recover will have a major impact on our own prospects and those of the entire world. The developing countries actually held up remarkably well through the third quarter of last year, lending credence to the “decoupling” concept and even the “reverse coupling” idea that they could sustain the world as a whole. Led by China and India, they are still doing much better as a group than the industrialized countries (see table 1) but many of them have also fallen off a cliff over the past six months.

Any effective global recovery strategy must therefore accord a central role to this group of nations. In addition to rapidly shrinking markets for their exports, they have experienced a huge cutback in private capital inflows. They need offsetting support from public investment, which only the International Monetary Fund can provide in sizable amounts on short notice.

The G-20 should thus direct the IMF to undertake three major new programs. First, it should inject liquidity with little or no conditionality to developing countries who have suffered sharp declines in exports or capital inflows due to the global slowdown rather than any policy errors of their own. This could require as much as \$500 billion of additional resources for the Fund, which should mainly be provided by the large surplus countries with excessive foreign exchange reserves (notably China, the major oil exporters and Japan, which has already offered to contribute \$100 billion).

⁹ With exchange rates converted at purchasing power parity per the standard practices of the IMF and World Bank in calculating global economic totals.

Second, it should resume creating Special Drawing Rights, the international money inaugurated in the late 1960s to deal with reserve shortfalls of precisely the type feared by many developing countries today. An early creation of \$250 billion, which could be supported by the United States without new legislation, would ease the financial anxieties afflicting numerous countries and obviate the need for “new mercantilist” measures to build reserves by running large trade surpluses instead. If the crisis and “new mercantilism” pressures persist, a second and larger SDR allocation could be added later.

Third, the Fund should substantially increase its regular quotas to enable it to conduct its traditional, conditional lending programs on the much larger scale required by the current crisis. This would also provide an opportunity, which the richer countries must seize if the emerging markets are to accept the standstill on trade barriers and new IMF-WTO mechanism on currency manipulation described above, to substantially alter the governance structure of both the Fund and the World Bank by providing much larger shares for the newly important emerging markets. The European Union and the United States should also take the occasion to give up their anachronistic holds on the top positions at the IMF and World Bank, respectively, and substitute a merit-based selection system instead. This “grand bargain” has been espoused by Prime Minister Gordon Brown of the United Kingdom, who will chair the London summit, and should be strongly supported by the United States¹⁰.

Financial Regulatory Reform

Some G-20 leaders have attempted to focus the meetings of the group, both last November and upcoming next month, on reform of financial regulation at both the national and

¹⁰ The idea was initially proposed by my colleague Morris Goldstein in “A Grand Bargain for the London G-20 Summit: Insurance and Obeying the Rules,” VoxEU.org, February 19, 2009.

international levels. Such a view is fully understandable in light of the substantial contribution of inadequate regulation to bringing on the crisis. Reform is clearly needed to prevent a repetition of the current tragedy.

Such reform is a long-term rather than immediate project, however. This is partly because of the complexity of the issues and the consequent difficulty of addressing them quickly. But it is also because the current need is to promote renewed lending by financial institutions, on as large a scale as possible, and new steps to restrain that lending for prudential reasons would send mixed signals that could derail the recovery strategy. Most important, addressing this set of issues would divert attention from the overriding priority of promoting renewed growth. The G-20 in London should thus continue the process of moving toward reform that they began in Washington, and perhaps provide a bit more guidance to it, but spend most of their time on the first three issues outlined above.

Conclusion

The global economic and financial crisis requires a global policy response. The G-20 summit in London provides a unique opportunity to mobilize the needed cooperation among countries that make up the bulk of the world economy. The United States, and President Obama in particular, must play a decisive role in forging such agreement. I urge the Subcommittee to do everything that it can to promote this outcome.

Table 1: Growth Impact of the Current Crisis

Country	Pre-crisis	Crisis		Decline in growth 2008-09	Decline in growth 2009
	(avg. 2005-07)	(avg.2008-09)	2009	(% of 2005-07 growth)	(% of 2005-07 growth)
Italy	1.3	-1.4	-2.1	205.1	263.6
Japan	2.1	-1.5	-2.6	167.6	221.2
United Kingdom	2.6	-1.1	-2.8	139.8	206.0
Germany	2.1	-0.6	-2.5	128.8	220.2
France	2.1	-0.3	-1.9	114.4	191.3
United States	2.6	-0.4	-1.6	113.6	162.0
South Korea	4.8	-0.6	-4.0	111.5	183.9
Canada	2.9	-0.3	-1.2	108.6	141.4
Spain	3.7	-0.3	-1.7	106.7	145.7
Mexico	3.7	0.8	-0.3	80.0	108.0
Russia	7.3	2.8	-0.7	62.3	109.6
India	9.4	6.2	5.1	34.2	45.9
China	11.3	7.9	6.7	30.5	40.7
Brazil	4.1	3.8	1.8	7.5	56.2

Table 2: Estimates of Fiscal Stimulus in 2009, Percent of GDP

Country	IMF	JPMorgan	Difference	
			IMF-JPMorgan	JPMorgan as % of IMF
Argentina	1.3	0.5	0.8	38
Australia	0.8	2.4	-1.6	300
Brazil	0.3	0.3	0.0	100
Canada	1.5	1.1	0.4	73
China	2.0	2.1	-0.1	105
France	0.7	1.0	-0.3	143
Germany	1.5	1.3	0.2	87
India	0.5	5.0	-4.5	1000
Indonesia	1.3	0.0	1.3	0
Italy	0.2	0.1	0.1	50
Japan	1.4	2.0	-0.6	143
Korea	1.5	1.1	0.4	73
Mexico	1.0	1.4	-0.4	140
Russia	1.7	1.1	0.6	65
Saudi Arabia	3.3	n/a	n/a	n/a
South Africa	1.3	1.6	-0.3	123
Spain	1.1	1.9	-0.8	173
Turkey	0.0	0.0	0.0	n/a
United Kingdom	1.4	1.6	-0.2	114
United States	1.9	2.0	-0.1	105
Total-GDP Weighted				
PPP	1.4	1.8	-0.3	124
US\$	1.4	1.7	-0.2	115